DEPARTMENT OF STATE REVENUE

04-20120284.LOF

Letter of Findings Number: 04-20120284
Sales and Use Tax
For Tax Years 2008 through 2010

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales Tax – Imposition.

Authority: IC § 6-8.1-5-1; IC § 6-2.5-2-1; IC § 6-8.1-3-12; IC § 6-8.1-5-4; IC § 6-8.1-4-2; IC § 6-2.5-1-5; IC § 6-2.5-8-8.

Taxpayer protests the audit's sample methodology. Taxpayer also protests the imposition of sales tax on certain items.

II. Use Tax – Manufacturing Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-1; IC § 6-2.5-3-4; IC § 6-2.5-5; IC § 6-2.5-5-3; IC § 6-2.5-1-10; IC 6-2.5-5-4; IC 6-2.5-5-5.1; IC 6-2.5-5-6; 45 IAC 2.2-5-8; Indiana Dep't. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); General Motors, General Motors, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Dep't of Revenue, State of Indiana v. Kimball Int'l, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer protests the imposition of use tax on certain items.

STATEMENT OF FACTS

Taxpayer is an Indiana commercial printer. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had not paid the proper amount of sales tax for purchases made during the years 2008-2010 and had not collected and remitted the proper amount of sales tax as a retail merchant during that time. The Department therefore issued proposed assessments for sales and use tax and interest. Taxpayer protests a portion of the Department's determination of sales and use tax due. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as necessary.

I. Sales Tax–Imposition.

DISCUSSION

A. Audit Sample

Taxpayer protests the calculation of sales tax. Taxpayer states that the sales tax audit sample is not a fair representation of the audit periods. The Department notes that a notice of proposed assessment is prima facie evidence that the Department's claim for the unpaid tax is valid, as provided by IC § 6-8.1-5-1(c). The burden of proving the proposed assessment is incorrect rests with Taxpayer.

The Department first notes that sales tax is imposed by IC § 6-2.5-2-1, which states:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

The Department next notes that IC § 6-8.1-3-12(b) states:

The department may audit any returns with respect to the listed taxes **using statistical sampling. If the taxpayer and the department agree to a sampling method to be used, the sampling method is binding on the taxpayer and the department in determining the total amount of additional tax due or amounts to be refunded.**

(**Emphasis added**).

IC § 6-8.1-5-1(b), in relevant part, states:

"[I]f the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department. The amount of the assessment is considered a tax payment not made by the due date and is subject to IC 6-8.1-10 concerning the imposition of penalties and interest."

IC § 6-8.1-5-4(a) further provides:

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks. (Emphasis added).

During the Department's audit all sales records were available to the auditor, but, due to the volume of invoices, the auditor chose to use a sample method rather than go through all of the invoices. IC § 6-8.1-3-12.

Taxpayer argues that an audit sample period which consisted of only the first four months of the tax year 2008 was not a fair representation of the sales for the remainder of 2008, and all of the years 2009 and 2010. Taxpayer states that because of the economy and the mix of work processed for exempt customers throughout the three year period, a sample method of two months from each year would have been more accurate. Taxpayer notes that a customer that makes up twenty-seven (27) percent of the sample had reduced sales throughout the rest of 2008 and all sales in 2009 and 2012 with this customer were less than one (1) percent.

Taxpayer did not show, however, that sales to this customer were an aberration as compared to other periods. There could have been other customers in other time periods that had a similar impact on alternate sample periods. The Department has the authority to use methods considered necessary to determine a taxpayer's proper tax liability as provided by IC § 6-8.1-4-2. As noted above, it is Taxpayer who must show that the assessment is wrong and there is nothing in the statutes or regulations circumscribing an auditor's choice of time frames for projecting results unless a taxpayer can show that the method was unreasonable. It does not matter that Taxpayer's business with a specific customer was larger during the projection period than the entire audit period. The only relevant fact is that there was a transaction with the client during the projection period and Taxpayer has not demonstrated that this was an aberration as compared to other sample periods.

Therefore, based on the above, and due to the volume of invoices, the Department's method of choosing a specific time period from the overall audit period was reasonable.

Taxpayer also argues that another customer included during the sample audit period whose transactions constituted six (6) percent of the total sales, had an exemption certificate which was not taken into consideration. For reasons explained below in section C, the exemption certificate is not valid and therefore has no effect on the audit sample period.

Taxpayer may argue that a different approach to the sample population may have resulted in less tax liability, but it failed to demonstrate clear error on the part of the audit.

Therefore, Taxpayer's protest of the audit's sampling method is respectfully denied.

B. Shipping Charges

Taxpayer protests the imposition of sales tax on shipping charges. Taxpayer argues that because their delivery is done through third parties 95 percent of the time, the shipping charges should be exempt. Additionally, Taxpayer believes that the sales tax should not be charged on deliveries because the delivery charge is stated separately on the invoices.

The Department refers to IC § 6-2.5-1-5(a) which states in relevant parts:

> Except as provided in subsection (b), "gross retail income" means the total amount of consideration, including cash, credit, property, and services, for which tangible personal property is sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for:
>
> (1) the seller's cost of the property sold;
>
> (2) the cost of materials used, labor or service cost, interest, losses, all costs of transportation to the seller, all taxes imposed on the seller, and any other expense of the seller;
>
> (3) charges by the seller for any services necessary to complete the sale, other than delivery and installation charges;
>
> (4) **delivery charges**;
>
> (**Emphasis added**).

Taxpayer does not cite to any legal authority for its contentions. IC § 6-2.5-1-5(a) states clearly that delivery charges are considered part of the "gross retail income" and are therefore taxable – the fact that they are separately stated makes no difference. Again, Taxpayer has not cited to any statutes, regulations, or Indiana case that support the Taxpayer's position.

Taxpayer also argues that the sampling method used for the audit would have an effect on the proposed calculations of additional sales tax on shipping charges. However for the reasons discussed above, the audit sampling method was acceptable. As a result the shipping costs derived from the audit sample are acceptable as well.

Lastly, Taxpayer argues that exemption certificate would affect the shipping charges. For reasons discussed below in section C, the exemption certificate is not valid and therefore does not affect the shipping costs.

For the reasons explained above, Taxpayer's protest of the imposition of sales tax on shipping charges is denied.

C. Exemption Certificates

Taxpayer argues that an exemption certificate that was submitted at the time of the audit was not taken into consideration.

The Department first sites to IC § 6-2.5-8-8 which states:

> (d) A seller that accepts an incomplete exemption certificate under subsection (a) is not relieved of the duty to collect gross retail or use tax on the sale unless the seller obtains:
>
> (1) **a fully completed exemption certificate**; or
>
> (2) the relevant data to complete the exemption certificate;
>
> within ninety (90) days after the sale.

(e) If a seller has accepted an incomplete exemption certificate under subsection (a) and the department requests that the seller substantiate the exemption, within one hundred twenty (120) days after the department makes the request the seller shall:

(1) obtain a fully completed exemption certificate; or

(2) prove by other means that the transaction was not subject to state gross retail or use tax.

(**Emphasis added**).

The exemption certificate provided by the Taxpayer was not fully filled out by the client. Sections with pertinent information such as the clients name, address, TID, and the completion date of the certificate, were left blank. As a result, the exemption certificate cannot be considered "a fully completed exemption certificate." Therefore, Taxpayer's protest that it had an exemption certificate from a client is respectfully denied.

D. Maintenance Agreements

The Department's audit assessed sales tax on a maintenance agreement because "in the case of purchase agreements or option warranties, it is presumed that tangible personal property is in the form of updates that will be transferred and software maintenance agreements are to be subject to use tax."

Taxpayer protests the imposition of tax on the maintenance agreement. Taxpayer argues that no tangible personal property was exchanged under the agreement and therefore the maintenance agreement was merely for maintenance services. Taxpayer explains that it paid a flat monthly rate for three hours of maintenance consulting services. Taxpayer explained that it paid an additional hourly fee for additional time it spent on a project, as well as for any tangible personal property it received.

Taxpayer has documented that the service agreement was for three hours of consulting services, was paid monthly, and any time tangible personal property was purchased from the consulting company, sales tax was paid on the purchase at that time.

Taxpayer is therefore sustained on the issue of the maintenance agreement.

FINDING

Taxpayer's protests of the audit's sampling method, the imposition of sales tax on shipping charges, and the validity of an exemption certificate from a customer are denied.

Taxpayer is sustained on its protest of the assessment of sales tax on the maintenance agreement.

II. Use Tax – Manufacturing Exemption.

DISCUSSION

A. Tangible Personal Property

The Department assessed use tax on a stacker forklift, waste toner cartridges, and a dehumidifier. Taxpayer argues that these items are exempt from use tax.

When a taxpayer claims it is entitled to a tax exemption, it bears the burden of proving that the terms of the exemption have been met. Indiana Dep't. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003). The Department will strictly construe the exemption statutes against the taxpayer claiming the exemption. Id. Thus, "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 101(Ind. Ct. App. 1974). Accordingly, the taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. General Motors, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

Department refers to IC § 6-2.5-2-1, which states:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

Also, Indiana imposes a complementary use tax under IC § 6-2.5-3-2(a), which states:

An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

"Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). In effect and practice, the use tax is generally functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

An exemption from use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. IC § 6-2.5-5 et seq. IC § 6-2.5-5-3 provides an exemption for machinery, tools, and equipment directly used in the purchaser's direct production of tangible personal property.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. 45 IAC 2.2-5-8(a). Machinery, tools, and equipment are directly used in the direct production process if they have an immediate effect on the article being produced. 45 IAC 2.2-5-8(c). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production

process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." 45 IAC 2.2-5-8(c), example 1.

45 IAC 2.2-5-8(g) further states:

> "Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. **The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property**.
>
> (**Emphasis added**).

45 IAC 2.2-5-8(k) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product. The Department next notes that IC § 6-2.5-5-3 provides that commercial printing shall be treated as the production and manufacture of tangible personal property. "Commercial printing" is described in IC § 6-2.5-1-10 as a process or an activity, or both, that is related to the production of printed materials for others. The term includes receiving, processing, moving, storing, and transmitting, either physically or electronically, copy elements and images to be reproduced; plate making or cylinder making; applying ink by one or more processes, such as printing by letter press, lithography, gravure, screen, or digital means; casemaking and binding; and assembling, packaging, and distributing printed materials. The term does not include the business of photocopying.

A commercial printer is, therefore, entitled to an exemption for machinery, tools, and equipment that are directly used to perform the activities previously set out. This includes equipment (computers, scanners, etc.) that is used to perform what is commonly referred to as "prepress activities," which include the receiving, processing, moving, storing, and transmitting, either physically or electronically, of copy elements and images to be reproduced and plate-making or cylinder-making. Exempt prepress activities do not include drafting of copy or the creation of artwork for reproduction.

Commercial printers are also exempt from sales and use tax on purchases of capital equipment, consumables, and materials used in commercial printing under IC § 6-2.5-5-4, IC § 6-2.5-5-5.1, and IC 6-2.5-5-6. Like other manufacturers, commercial printers may also be exempt from tax under other sections of the Indiana Code.

Additionally, Taxpayer is classified as a retail merchant under IC § 6-2.5-5-3.

(1) Forklift

Taxpayer states that the forklift should be exempt because it "is used to unload paper, move skids, and transport to presses and put into racks during the entire manufacturing process." Taxpayer says it should therefore be entirely exempt. In order for a piece of machinery to be exempt it must be directly used in direct production of the Taxpayer's printed materials.

The Department first refers to IC§ 6-2.5-5-3(b) which states:

> Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for **direct use** in the **direct production**, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.
>
> (**Emphasis added**).

However some of the activities Taxpayer describes, such as unloading paper, are pre-production activities. 45 IAC 2.2-5-8(d) describes pre and post-production activities:

> Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

Taxpayer has provided sufficient documentation to show that the forklift is used in an exempt fashion at least part of the time. Taxpayer's exempt process begins with the placement of paper (or other items) into the printers and ends when the printed materials are in their final form. Any other activities are considered to be pre or post-production. A supplemental audit will determine the percentage of the exemption. Taxpayer however must send in documentation – within thirty (30) days of the date of this Letter of Findings – that shows how much time the forklift is used for each of the operations Taxpayer describes.

The Taxpayer is sustained on the forklift to the extent that it is directly used in direct production as determined by a supplemental audit.

(2) Toner Waste Cartridges

Taxpayer argues that the waste toner cartridge for the colored ink should be exempt. According to Taxpayer, the purpose of a waste toner cartridge is to contain the toner waste collected during the printing process. While

containing the toner waste may be necessary, it does not satisfy the "double direct" test provided in IC § 6-2.5-5-3(b) which states that the property must be directly used in the direct production of a product.

Here the waste toner cartridge is not part of direct production. Once the paper has been printed upon, the leftover/waste toner is no longer part of production. Therefore the cartridges used solely for holding toner waste are not directly used in direct production.

Taxpayer's protest of the assessment of use tax on the toner waste cartridge is respectfully denied.

(3) Dehumidifier

Taxpayer argues that its dehumidifier should be exempt from use tax because it is necessary for climate control in the press room. Taxpayer states that the dehumidifier is necessary for the total manufacturing/printing process because if the paper absorbs moisture it will not process through the printers properly. Taxpayer argues that but-for the dehumidifier Taxpayer would not be able to conduct its business of printing.

In addition to the law stated above, 45 IAC 2.2-5-8 (j) provides:

> **Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax**. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; **ventilation and cooling for general temperature control**; illumination; heating equipment for general temperature control; and shipping and loading.
>
> (**Emphasis added**).

Therefore, while as a commercial printer, some of the items Taxpayer uses in its production process may qualify for the manufacturing exemption, not all of the items Taxpayer uses will be exempt.

The Department refers to RCA Corp. In this case the taxpayer, RCA Corp., claimed that it purchased certain environmental control equipment, i.e., air conditioning equipment, to be directly used in the direct production of color television picture tubes, and, therefore, was exempt from sales/use tax. RCA Corp., 310 N.E.2d at 97-98. In making its case, RCA Corp. argued that the environmental control equipment was "used to control the temperature, humidity and presence of foreign particles in the air, in around and on the surface [sic] of color television picture tubes during the manufacturing process." Id. The trial court agreed with the RCA Corp., but the Indiana Court of Appeals (" RCA Court") disagreed. Reversing the trial court's decision, the RCA Court ruled in favor of the Department. Applying the "double direct standard," the RCA Court found that:

> Whatever effect (whether positive or negative) that RCA's air conditioning or environmental control equipment may have on the tubes RCA manufactures, or on the process of their manufacture, is exerted through the medium or agency of the environment (i.e., the air). The very name of the equipment, whether 'air conditioning' or 'environmental control', signifies that its immediate effect is on the surroundings in which the manufacturing process takes place and only remotely, through the intervening agency of those surroundings, on the tubes or on the process by which they are manufactured. Id. at 100.

The RCA Court thus determined that RCA Corp. was not entitled to the manufacturing exemption for its purchase of the environmental control equipment/air conditioning equipment.

The Indiana Court of Appeals subsequently addressed a similar issue, but on a different set of facts and circumstances, in Dep't of Revenue, State of Indiana v. Kimball Int'l, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988). In Kimball, the taxpayer, Kimball International, manufactured "finished wood products and components, including pianos, speaker cabinets and furniture." Id. at 455. Kimball International claimed that it was entitled to the manufacturing exemption on its purchases of "spray booths, air make up units, and their associated component parts." Id. Ruling in favor of Kimball International, the Indiana Court of Appeals (" Kimball Court") explained, in pertinent part, that:

> The spray booth and air make up units come into play during the final phase of the manufacturing process, when the finish is applied. After the wood products are assembled and prepared, they are moved by conveyor into finishing rooms. The finishing rooms are isolated from the rest of each plant by separate walls and positive air pressure. The spray booths and air make up units are found inside the finishing rooms.
>
> The spray booths are three-sided structures and also include fans, water baths and duct work. The spray booths are designed so that overspray and evaporated solvents are exhausted from the finishing rooms through the water baths and duct work to the outside.
>
> The air is exhausted from the finishing rooms at a rate of 120,000 cubic feet per minute, thus creating a need for an air in-take system. This is the function of the air make up units which include fans, filters, heaters and duct work. In addition to bringing in outside air, the air make up units heat the air and control its humidity. Id.

The Kimball Court, through expert testimony and exhibits, found that Kimball International used the spray booths and air make up units to prevent a "blushing" condition in the manufacturing process so it's finished products can be "saleable." Id. The Kimball Court also found, in relevant part, that:

> It was undisputed that collecting and removing the excess spray by use of the spray booths, spray booth coatings, water baths, and paint deflocculents is critical from a safety standpoint. The chemicals Kimball uses

are highly flammable and without constant cleansing, the air in the finishing rooms would quickly become explosive.

It was also uncontroverted that the combination of the air make up units and the spray booths creates an airflow that is essential to the manufacturing process. This air movement promotes drying of the newly applied finish. Without this pre-drying a condition called "blistering" would occur during the later oven drying stage whereby trapped solvents would create bubbles in the finish. The airflow is also responsible for controlling sags and runs in the newly applied finish by improving the uniformity of the spray.

Id.

The Kimball Court thus concluded that Kimball International met its burden of proof and was entitled to manufacturing exemption on its purchases of spray booths, air make up units, and the associated component parts.

In Taxpayer's case, the use of the dehumidifier is more like the use of air conditioning in RCA Corp. The dehumidifier may be necessary or even essential to the production process but necessity is not enough to qualify the dehumidifier as exempt as described above in 45 IAC 2.2-5-8(g).The dehumidifier used in Taxpayer's process dehumidifies the surrounding air, but does not have a direct effect on the product being produced. Only clearly demarcated areas in which there is active manufacturing that depends on a controlled environment are entitled to the exemption. In Taxpayer's facility, the dehumidifiers operate to "condition" the environment within that facility rather than a specific, demarcated area within that facility (as is the case in Kimball).

Taxpayer has not presented any documentation that suggests the dehumidifier is used in a manner more akin to the air makeup units used in Kimball. As a result the dehumidifier does not qualify for the manufacturing exemption.

Therefore Taxpayer's protest of the imposition of use tax on the dehumidifier is respectfully denied.

B. No Documentation

Taxpayer protests the imposition of use tax on a portion of the audit labeled "no documentation." During the audit period, Taxpayer had made purchases from various vendors but did not have supporting documentation to show that either sales tax was paid or that the purchase qualified under an exemption. As a result, use tax was imposed.

The purchases in question include payments for web hosting, software, annual membership dues to an organization, French paper, imprinted beads, chocolate coins, imprinted flags and payments for internet service.

Taxpayer has provided sufficient documentation to establish that the French paper, imprinted beads, chocolate coins and flags were all items it printed on. Taxpayer has also provided sufficient documentation to establish that the payments for web hosting, software and annual membership dues were not subject to sales tax.

FINDING

Taxpayer's protests of the imposition of sales tax on the dehumidifier and toner waste cartridge are denied.

Taxpayer's protest of the imposition of sales tax on the forklift is sustained pending a supplemental audit.

Taxpayer's protest of the imposition of sales tax on the French paper, imprinted beads, chocolate coins and flags, as well as web hosting, software and annual membership dues is sustained.

SUMMARY

Taxpayer's protests of the audit's sampling method, the imposition of sales tax on shipping charges, and the validity of an exemption certificate from a customer are denied.

Taxpayer's protests of the imposition of sales tax on the dehumidifier and toner waste cartridge are denied.

Taxpayer's protest of the imposition of sales tax on the forklift is sustained pending a supplemental audit.

Taxpayer's protest of the imposition of sales tax on the French paper, imprinted beads, chocolate coins and flags, as well as web hosting, software and annual membership dues is sustained.

Posted: 09/25/2013 by Legislative Services Agency
An html version of this document.